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An examination of related party
transactions disclosure policies and
practices of schedule C and D Crown
Corporations.

(Discussion paper no. 35)

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Office of the
Auditor General
of Canada



Bureau du
vérificateur général
du Canada

DISCUSSION PAPER NO. 35

AN EXAMINATION OF RELATED PARTY
TRANSACTIONS DISCLOSURE POLICIES
AND PRACTICES
OF SCHEDULE C AND D CROWN CORPORATION
BY

Mark Greenfield & Michael Weir

AUGUST 1984

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Purpose of the Paper

The purpose of this paper is to describe a survey of related party transactions and economic dependence disclosure policies and practices carried out by the Financial Reporting Standards (FRS) group. The survey stems from the commitment made in Bulletin 81-3, Disclosure of Related Party Transactions and Economic Dependence in the Annual Financial Statements of Schedule C and D Crown Corporations, that the group would monitor the practices being followed in both the private and public sectors. With related party reporting practices still in their infancy at the time of the Bulletin's release, FRS was designated as a monitoring mechanism to help ensure that appropriate disclosure was made by Crown corporations and entities audited by the Office of the Auditor General (OAG). Analysis of the survey results indicates that shortcomings identified in related party reporting by OAG audited entities could be addressed by refining policies promulgated in Bulletin 81-3.

The paper has four basic components. First, the rationale for related party disclosure is reviewed. Next, the survey methodology is discussed, and its findings analysed. The paper then explores the implications of the survey results on Bulletin 81-3, and, finally, sets out our recommendations.

Rationale for Disclosure of Related Party Transactions

Transactions between related parties are common in the normal course of business. The Financial Accounting Standards Board's SFAS 57 gives the following examples of transactions frequently occurring between related parties: sales, purchases, and transfers of real and personal property; services rendered or received, for example, accounting, management, engineering and legal services; use of property and equipment by lease or otherwise; and borrowings, lendings and guarantees. Transactions between related parties are considered to be related party transactions regardless of whether they have been afforded accounting recognition.

Given the potential impact and widespread occurrence of such transactions, accounting standards setters in Canada and the United States responded by issuing CICA Handbook Section 3840 and SFAS 57, respectively. Both standards are designed to aid the financial statement user in understanding the manner and extent to which transactions with related parties have contributed to the financial position and results of operations of the reporting entity. The Canadian standard also addresses the question of the reporting entity's dependence on a significant volume of transactions with another entity, whether or not the parties are related.

In order to meet its objectives, the CICA's Accounting Standards Committee established the following disclosure recommendations in Section 3840:

- (a) a description of the nature and extent of transactions;
- (b) a description of the relationship; and
- (c) amounts due to or from related parties and, if not otherwise apparent, the terms of settlement.

To convey the extent of related party transactions, the Handbook section states that "it would be appropriate to disclose their recorded dollar amounts, supplemented by information to indicate the proportion of the enterprise's activities which involves related parties, if not otherwise apparent." Such disclosure is mandatory in the United States.

Survey Methodology

We undertook a survey to evaluate the related party disclosure provided by OAG audited entities against the standards promulgated by the CICA. Its scope encompassed all Schedule C and D Crown corporations audited by the OAG for which 1983 financial statements were published in Volume III of the Public Accounts.

To provide a benchmark against which these corporations' related party reporting could be measured, the financial statements of Schedule C and D Crown corporations audited by public accounting firms and published in the 1983 Public Accounts, and exemplary statements published by public corporations, were also surveyed. Statements of twenty public corporations whose annual reports were highly rated in a Canadian business publication competition held in 1983 were selected. These statements were judged in the competition on the basis of their overall excellence, rather than on any one specific criterion such as the quality of related party presentation. Therefore, we believe the comparison to be valid since the public corporations sample was unbiased by including statements solely on the basis of their related party reporting excellence.

The number of corporations included in the survey is as follows:

Schedule C and D Crown Corporations

Audited by the OAG	33
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Audited by public accounting firms	<u>14</u>
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	47
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Public corporations	<u>20</u>
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	<u>67</u>
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The corporation whose statements were included in the survey are listed in Appendix 1.

Disclosure was examined according to the following criteria:

- (1) **Completeness.** Identification and disclosure of related party transactions constitute primary audit risks. To address this concern, FRS attempted to evaluate the completeness of disclosure of non-financing transactions, which tend to be more difficult to identify and disclose in a meaningful way. Public corporations surveyed were not evaluated in this regard given the difficulties involved in establishing whether disclosure completeness had indeed been achieved.

- (2) **Content.** The transactions identified in the statements were taken as given, and disclosure content was examined to evaluate conformity with CICA recommendations regarding descriptions of both the relationship and the transactions entered into.
- (3) **Clarity.** Related party transactions can have a profound impact on the results of operations and financial position of an entity. A succinct, clear and comprehensive description of this impact would be consistent with the objectives of Section 3840. To this end, we evaluated statement performance in terms of clarity.

Survey Results

The survey results are listed according to these three criteria.

Completeness. While completeness is difficult to ascertain in the absence of field work, the survey identified a number of instances where significant non-financing transactions such as audit, legal, accommodation and accounting services were received or rendered but not acknowledged in the financial statements of OAG audited entities. Given the pervasive nature of non-financing related party transactions entered into by Crown corporations, we believe this area poses a high audit risk, given the difficulties encountered by the auditor in identifying and evaluating such transactions.

On the other hand, financing transactions, which include parliamentary appropriations, loans from Canada and equity infusions, are more readily verified. Confirmations from the Government of Canada are an integral part of the process of obtaining sufficient and appropriate audit evidence of statement completeness, proper measurement and presentation. Since audit risk in this area is lower, discussion of disclosure completeness is limited in this paper to non-financing transactions disclosed by Crown corporations.

For instance, in the area of services received with or without charge from government departments, the survey revealed the following:

	Service Received			
	Audit	Legal	Accommo- dation	Accounting/ Administration
OAG audited Crown corporations				
Approximation of applicability	33	15	15	5
Number reporting such services	1	2	2	2
Crown corporations not audited by the OAG				
Approximation of applicability	-	1	1	5
Number reporting such services	-	-	-	3

These estimations of entity applicability were established by contacting those departments known to provide services to Crown corporations. The departments involved were Justice, Public Works, and Supply and Services.

While it should be pointed out that in some instances such services would not be judged to be significant to operations and thus not worthy of disclosure, others are indeed reportable. Moreover, other significant transactions not enumerated above constitute related party transactions and remain undisclosed.

Content. The examination of the content of related party transactions disclosure indicates that the quality of the information provided is uneven across corporations and within given financial statements. The survey revealed that in those Crown corporations referring to non-financing transactions with Canada or with other Crown corporations, less than half attempt to indicate their extent. On the other hand, such attempts are made by nearly all the entities not audited

by the OAG included in our survey. The trend continues in the presentation of receivables or payables at year end. For entities not audited by the OAG, the percentage of the sample disclosing such information ranges from 40 to 55. Only 10 per cent of OAG audited entities disclosed receivables or payables relating to non-financing transactions. One might infer that this is due to fewer material outstanding balances in the case of OAG audited entities. If this is the case, financial statement disclosure of such would be meaningful information to the statement reader.

Percentages of corporations referring to non-financing transactions
which disclose the following:

	Crown corporations audited by		<u>Public Corporations</u>
	<u>OAG</u>	<u>Others</u>	
Extent of non-financing transactions	45	100	90
Disclosure of receivables/payables	10	40	55

While disclosure of financing transactions by OAG audited entities is adequate for the current and comparative periods, cumulative information regarding cash infusions by Canada is not readily determinable in most Crown corporations. The CICA Public Sector Accounting and Auditing Committee issued an Exposure draft in February 1984 entitled Objectives of Government Financial Statements. It stated that "users look to financial statements to provide information to show the allocation and use of financial resources". We raise the question as to whether such cumulative information would be useful to decision makers as well as other financial statement users in this regard.

While not necessarily pertaining to related parties per se, our survey identified three instances in which economic dependence upon Canada was explicitly stated by OAG entities. The circumstances were: sales almost exclusively to the Government of Canada, dependence upon loans from Canada, and the need for continued funding of operations. Given the fact that the latter

two circumstances are not unique to these corporations, there appears to be considerable inconsistency in the application of CICA Handbook paragraph S.3840.18. Corporations with a strong financial position and net income due to the receipt of parliamentary appropriations may not appear as dependent upon Canada as, in fact, they are. Explicit acknowledgement of economic dependence is therefore desirable in the financial statements in instances where the continuing operations of Crown corporations are dependent upon substantial parliamentary appropriations, loans or other forms of financing ultimately received by virtue of the corporations' relationship with the Government of Canada.

Clarity. The objective of CICA Handbook Section 3840 is to assist the financial statement user in understanding the manner and extent to which related party transactions have affected the financial position and results of operations of the enterprise. While clear presentation is crucial in meeting this objective, it is rarely seen in the financial statements of most entities audited by the OAG.

As demonstrated in the following table, there have been few attempts to provide cross-references to the disclosure locations of financing and non-financing transactions with Canada and with other Crown corporations, or to comment on their overall significance to the corporation.

Percentage of corporations providing a related
party transaction note (of any title):

<u>Crown corporations audited by</u>		<u>Public Corporations</u>
<u>OAG</u>	<u>Others</u>	
25%	50%	70%
==	==	==

Financial statements of public corporations were notably superior in cross-references from the related party note to other note disclosure of a related party nature. Given the dependence of most OAG audited entities on government

support, this format is as necessary, if not more so, in the public sector in order to attain the objectives of CICA Handbook Section 3840.

Implications on Bulletin 81-3

The following is a summary of the survey results. First, the related party disclosure of some OAG audited entities is incomplete. Second, the information is often provided in a disjointed form that makes assessments of the nature of related party transactions and the extent of their effect on the entity difficult. Both of these points can be addressed by refining the policies promulgated in Bulletin 81-3. Format of presentation is a straightforward concern and is discussed first. The paper then turns to the matter of related party transactions deemed reportable by the auditor. While related party transactions identification procedures have not been addressed in this paper, they are, of course, critical to the audit process. Accordingly, Appendix 2 has been attached as an enumeration of procedures the auditor should consider in obtaining reasonable assurance that related party transactions have been identified and appropriately considered for disclosure in the financial statements.

Given the fundamental impact of related party transactions on OAG audited entities, we recommend that notes be provided in all cases where it has been determined that reportable transactions have occurred. The note's fundamental purpose is to provide the reader with a readily available indication of the nature and extent of related party transactions. To this end, we believe that Office policy should stress the importance of evaluating the business purpose of related party transactions in order to estimate values of significant non-financing transactions. As well, all notes presenting information of a related party nature, such as long-term debt from Canada, should be appropriately cross-referenced to the related party note.

An example of such a note, which fully meets the criteria established in our survey, is drawn from the 1984 statements of Northern Canada Power Commission.

Related party transactions

In addition to the transactions described in Notes 4 and 5, the Commission has significant transactions with the Government of Canada and its agencies, as well as with territorial and municipal governments of the Northwest Territories and the Yukon Territory. These transactions and resulting balances comprise:

	<u>1984</u> (thousands of dollars)	<u>1983</u>
Sale of power and heat	\$ 42,964	\$ 36,529
Purchase of fuel	7,815	6,460
Contributions to the Public Service Superannuation Plan	655	641
Treasury bills and accrued interest	11,948	-
Accounts receivable	4,783	4,277
Accounts payable	1,287	1,593

Furthermore, the Commission receives audit and legal services without charge from the Office of the Auditor General of Canada and the Department of Justice of Canada.

However, our more fundamental concern is directed toward policies stated in Bulletin 81-3 for determining which related party transactions known to the auditor should be disclosed.

The Bulletin states that "since all Crown corporations are owned by Canada, transactions between a Crown corporation and Canada, or between Crown corporations, are deemed to be related party transactions..." This position is consistent with CICA Handbook Section 3840, which states that parties are considered to be related when one party has the ability to exercise, directly or indirectly, control or significant influence over the operating and financial decisions of the other. Since all Crown corporations are owned by Canada, the ability to exercise control can be presumed to exist.

The Bulletin then goes on to indicate that in the case of transactions with Canada or with other Crown corporations:

in most cases, disclosure should be limited to transactions that are significant to the corporations operations and made by virtue of the corporation being part of government. The need for disclosure of transactions between government entities that are also made on a similar basis with individuals or privately owned corporations (i.e., transactions made as 'private citizens') is less clear. In many cases, these transactions would be immaterial to the financial statements of the reporting entity and disclosure would not provide useful information to statement users.

We examined the OAG policy stemming from a CICA recommendation by a two-step process. We scrutinized the intent of the policy itself, then the way it is interpreted by audit staff. The OAG policy concerning related parties was established at a time when related party reporting was still early in the developmental stages. It appears to advocate non-disclosure in most cases of transactions between Crown corporations and between Crown corporations and Canada for various services rendered or received. This is based on the judgement that the transactions were made on a basis similar to those which would have been made with individuals or privately owned corporations.

Few will argue that disclosure of routine transactions such as UIC/PPP remittances and other routine transactions is meaningful to the statement reader, as was stated in Bulletin 81-3. However, transactions of a nature significant to the entity should be disclosed, regardless of whether they are comparable to transactions entered into by private parties with Canada or Crown corporations.

Such disclosure is essential if the manner and extent that transactions with Canada and other Crown corporations have contributed to the financial position and results of operations of the reporting entity are to be fairly presented in the financial statements. If used in the private sector, this approach would delete from disclosure those related party transactions carried out at fair market value, i.e., terms at which the transaction would be valued for any given private

person or organization in the normal course of business. While this approach was suggested in the 1979 research study by A.K. Mason, it has been rejected by both the CICA and FASB.

Interpretation of related party disclosure policies promulgated in Bulletin 81-3 is also of concern. Audit teams have indicated that there is an element of ambiguity in Bulletin 81-3, i.e., determining which transactions should or should not be disclosed. It would appear that using a broader measure, (e.g., significance to the entity and readers of its financial statements) would avoid artificial interpretations of the policy as it now stands. Such ambiguities should be clarified to the extent possible to ensure that audit teams exercise professional judgement based on policies whose underlying basis is thoroughly understood in all respects.

Therefore, in our view, disclosure decisions should not rest on whether terms of transactions are equivalent to those available to parties outside the public sector, but instead on whether the transactions are significant to the financial position and/or results of operations of the entity. Using this approach, our audit work will indeed address the objective behind related party reporting in its entirety.

Recommendations

This paper was intended to stimulate thought on Office policies for disclosure of related party transactions. By means of a survey, we evaluated OAG entity reporting against the objective of related party disclosure and Crown corporations not audited by the Office, as well as a number of public corporations. The survey indicated that disclosure format and content could be improved to ensure the information disclosed meets the objectives of the standard under which it is being reported. More important, however, we recommend a broader definition of reportable related party transactions to ensure that all such transactions significant to OAG entities are reported. Only then can we be assured of our compliance with the professional standards under which we practice.

Corporations Included in the Survey

A. Entities audited by the Office

1. Atlantic Pilotage Authority
2. Atomic Energy of Canada Limited
3. Canada Deposit Insurance Corporation
4. Canada Harbour Place Corporation
5. Canada Museums Construction Corporation Inc.
6. Canada Post Corporation
7. Canadian Arsenal Limited
8. Canadian Broadcasting Corporation
9. Canadian Commercial Corporation
10. Canadian Dairy Commission
11. Canadian Film Development Corporation
12. Canadian Livestock Feed Board
13. Canadian National (West Indies) Steamships Ltd.
14. Canadian Patents and Development Limited
15. Canadian Saltfish Corporation
16. Crown Assets Disposal Corporation
17. Defence Construction (1951) Limited
18. Export Development Corporation
19. Farm Credit Corporation
20. Freshwater Fish Marketing Corporation
21. Great Lakes Pilotage Authority, Ltd.
22. Laurentian Pilotage Authority
23. Loto Canada Inc.
24. National Battlefields Commission
25. National Capital Commission
26. Northern Canada Power Commission
27. Pacific Pilotage Authority
28. Royal Canadian Mint
29. The St. Lawrence Seaway Authority
30. The Jacques Cartier and Champlain Bridges Incorporated
31. The Seaway International Bridge Corporation, Ltd.
32. Teleglobe Canada
33. Uranium Canada, Limited

B. Crown corporations not audited by the Auditor General

1. Air Canada
2. Canada Development Investment Corporation
3. Canadair Limited
4. De Havilland Aircraft of Canada, Limited
5. Eldorado Nuclear Limited
6. Canada Ports Corporation
7. Canada Mortgage and Housing Corporation
8. Canadian National Railway System
9. Canadian Wheat Board
10. Cape Breton Development Corporation
11. Federal Business Development Bank
12. Northern Transportation Company Limited
13. Petro-Canada
14. VIA Rail Canada Inc.

C. Public corporations

1. Amca International Ltd.
2. Bramalea Ltd.
3. British Columbia Hydro & Power Authority
4. Canada Cement Lafarge Ltd.
5. Canada Development Corp.
6. Canada Trustco Mortgage Co.
7. Dome Mines Ltd.
8. Domtar Inc.
9. Dylex Ltd.
10. Genstar Corp.
11. Grafton Group Ltd.
12. Imperial Oil Ltd.
13. Inco Ltd.
14. Maclean Hunter Ltd.
15. Massey-Ferguson Ltd.
16. Northern Telecom Ltd.
17. Royal Bank of Canada
18. Suncor Inc.
19. Trizec Corp.
20. Westcoast Transmission Co.

Procedural Guide for Identification and Financial Statement
Disclosure of Related Party Transactions

Audit Objectives

To obtain appropriate evidence that related party transactions entered into by the entity are adequately disclosed in the financial statements.

Determining the Existence of Related Parties

1. Have you evaluated the entity's procedures for identifying and properly accounting for related party transactions?
2. Have you inquired of appropriate management personnel as to the names of all related parties and whether there were any transactions with these parties during the period?
3. Have you compared information obtained from management with your own knowledge of the entity and its related parties as well as prior year's workpapers?
4. Did you review filings, such as corporate income tax returns, with governmental and regulatory agencies for the names of related parties and for other business in which officers and directors occupy directorship or management positions?
5. Did you review stockholder listings (if applicable) to identify principal stockholders?
6. Have you inquired of predecessor, principal, or other auditors of related entities as to their knowledge of existing relationships and the extent of management involvement in material transactions?
7. Have you reviewed material investment transactions during the period under examination to determine whether the nature and extent of investments during the period created related parties?
8. Were corporate policies regarding the authorization of transactions with related parties reviewed?

Identifying Transactions With Related Parties

9. Were audit personnel provided with the names of known related parties so that they may become aware of transactions with such parties in the course of their work?

10. Did you review the minutes of meetings of the board of directors and executive and auditing committees for information as to material transactions authorized or discussed at their meetings?
11. Did you review "conflict-of-interest" statements obtained by the entity from its management?
12. Did you review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships?
13. Have you considered whether transactions are occurring, but are not being given accounting recognition, such as receiving or providing accounting, management, or other services at no charge or absorption of corporate expenses by a government department?
14. Did you review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period?
15. Have you reviewed invoices and other correspondence from lawyers that have performed regular or special services for the company for indications of the existence of related parties or related party transactions?

Examining Identified Related Party Transactions

16. Have you obtained an understanding of the business purpose of the transaction?
17. Did you examine invoices, executed copies of agreement, contracts, and other pertinent documents, such as receiving reports and shipping documents?
18. Did you determine whether the transactions has been approved by the board of directors or other appropriate officials?
19. Have tests for reasonableness of compilation of amounts to be disclosed, or considered for disclosure, been performed?
20. Have audits of specified, important and representative intercompany/related party transactions been co-ordinated to be performed as of concurrent periods with an appropriate exchange of the relevant information by respective audit teams?

Disclosure

21. Do the financial statements of the reporting entity adequately disclose material related party transactions? Disclosure should include the following:

- (a) a description of the nature and extent of transactions;
- (b) a description of the relationship;
- (c) amounts due to or from related parties and, if not otherwise apparent, the terms of settlement.

To convey the extent of related party transactions, the CICA Handbook indicates that it would be appropriate to disclose their recorded dollar amounts, supplemented by information to indicate the proportion of the enterprise's activities which involves related parties, if not otherwise apparent. Adequate disclosure of related party transactions includes transactions not given accounting recognition, including services provided or received without charge.

Conclusion

22. Have you prepared a brief concluding memorandum highlighting the results of testing, significant changes from prior years, any departures from the entity's policies and procedures, along with any considerations for subsequent years? This memorandum should state a conclusion as to the attainment of audit objectives.

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